

Interest Rates are Rising: Should I Get Out of Bonds?

As interest rates rise, bond prices fall. And that certainly occurred the first two months of the second quarter. April was the second worst month in the last ten years for the U.S. bond market, and May also delivered negative returns for bond investors.ⁱ

So many investors are naturally asking the question, “Should I get out of bonds?”

Good News: Yields are Higher

If you liked bonds in March, you have to like them now. Without sounding flippant, the fact is bond yields are much higher than they were at the beginning of the quarter, and that can be a good thing. Over longer periods of time, it's yield that counts. Yield dominates price over long horizons. For example, in the ten years ending 2003, 95% of the bond market's total return came from coupon incomeⁱⁱ. Bond prices rise and bond prices fall, but coupon payments continue. Time is on the side of the bond investor, and eventually higher yields can more than compensate for any price loss.

Thus, rising interest rates are both bad news and good news for bond investors. The bad news is that rising interest rates result in lower prices. The good news is that rising interest rates also result in higher yields, which eventually will outweigh a loss in price as cash flows are reinvested at higher interest rates.

Historical Perspective

The prior two periods of rising interest rates occurred in 1994 and 1999, both periods of monetary tightening by the Federal Reserve. It is interesting to note that following three months of negative returns in early 1994, the bond market experienced a positive return through year-end. Similarly, in 1999 the bond market recorded positive returns excluding the initial 'bad' month of February, when the markets realized the Federal Reserve was about to push rates higher.

In comparison, April 2004 posted a worse return than any single month of either 1994 or 1999, as the market priced in a Federal Reserve poised to remove monetary stimulus. If 2004 end up being a repeat of 1994 and 1999, the worst might be over for bond markets.

So, What Should I Do?

First and foremost, don't panic. It is quite possible (it certainly was the case in 1994 and 1999) that the worst is over, and bonds are the place to be. Next, don't forget why you are in bonds.

- Bonds provide income. Even if prices decline, the income stream from the coupon doesn't change. Indeed, as interest rates rise (and prices fall), the income stream increases as cash flows are reinvested at higher interest rates.
- Bonds are much less volatile than stocks. Over the last twenty years, the worst calendar year return for the bond marketⁱ was -2.8% in 1994, versus -22.0% for the S&P 500 in 2002.
- Bonds provide diversification. Often we focus too much attention on returns and not enough attention on the other side of the risk-return equation. One of most powerful tools to reduce risk is diversification, and bonds can be an important component of a well-diversified portfolio.

If you still have concerns about your portfolio's allocation to bonds, you might consider switching to lower risk sectors of the bond market. While it is generally difficult to time the markets, there are segments of the bond market that have less price risk than others. Specifically, short and intermediate maturity bonds, and mortgage bonds have less price exposure to rising interest rates. Historically all three have outperformed the overall bond market during periods of rising interest rates.ⁱⁱⁱ

In summary, if you find yourself asking the question "Should I get out of bonds," take a deep breath, a historical look, and a long-term view. Bonds might very well be the very best place to be!

The opinions expressed herein are not intended as a forecast of future events, a guarantee of future results or investment advice. Read the prospectus carefully before you invest or send money.

ⁱ As measured by the Merrill Lynch Domestic Master Index, which is an unmanaged index made up of U.S. Treasury, Agency, Mortgage, and investment grade Corporate issues with maturities from one to thirty years.

ⁱⁱ The Merrill Lynch Domestic Master Index had a total return of 6.97% from December 31, 1993 through December 31, 2003, with price return of only 0.36%.

ⁱⁱⁱ For example, in 1994 the Merrill Lynch Domestic Master Index returned -2.8%, versus -1.6% for the Merrill Lynch Mortgage Index, +0.6% for the Merrill Lynch U.S. Corporate & Government 1-3 Yr Index, and -1.7% for the Merrill Lynch U.S. Corporate & Government 1-10 Yr Index.